

## PROPOSED FINANCIAL REGULATION REFORM

With Congress back in session this week, most commentators believe health care reform will take up all of Congress's attention, so that financial market reforms will proceed slowly if at all. On August 11, however, while Congress was on its August recess, the Treasury Department completed its extensive proposed legislation for "financial regulation reform" by sending to Congress the draft legislation titled "Over-the-Counter Derivatives Markets Act of 2009." The entire package is made up of 17 separate proposals divided into 13 separate "titles", with "Title IX" divided into 5 "subtitles." Lengthy laws, like Super Bowls, use roman numerals.

In general, the proposed legislation gives new discretion to federal regulators rather than imposing specific rules in areas of the financial markets that have been criticized for playing a role in the financial crisis that emerged in 2007. New federal regulators would be given authority over the vast consumer finance market and some oversight authority for financial risk in the insurance industry. Existing regulators would be given new authority over any company or "facility" they determine is a "threat" to the financial system or broader economy, new authority over private pools of capital, and new authority to determine what derivatives must be traded and cleared on regulated facilities and to establish requirements for derivatives transactions that are not conducted through such regulated facilities.

A brief summary of each of the 17 proposals follows.

### **Title I - Financial Services Oversight Council**

Title I would replace the President's Working Group on Financial Markets with a larger Financial Services Oversight Council that would broadly monitor and discuss financial markets.

The members of the new Oversight Council would be the Treasury Secretary, the heads of the CFTC, FDIC, FHFA and Federal Reserve and the heads of the new Consumer Financial Protection Agency and National Bank Supervisor described below.

### **Title II - Tier 1 Financial Holding Companies**

Title II would give the Federal Reserve, in consultation with the Oversight Council, the power to designate a company a Tier 1 financial holding company (a "Tier 1 FHC"). In this proposed legislation the Federal Reserve could designate as a Tier 1 FHC any company engaged in finance, even if its business were primarily manufacturing or some other non-financial activity. The critical criterion is whether "material financial distress at the company" could threaten financial stability in, or the economy of, the US (or, for domestic US companies, the world) "during times of economic stress."

Observers think this criterion will at least cover the 19 large bank holding companies included in last spring's SCAP (supervisory capital assessment program). It may also cover large commercial holding companies and large insurance holding companies that have significant finance activities. Any such non-bank holding company would need to conform its activities to the limits that apply to bank holding companies. As a practical matter, this would force a commercial holding company to separate its commercial activities from its finance activities. During the 5 year period permitted for such a divestiture, the commercial holding company would need to establish (within 90 days of being designated a Tier 1 FHC) an intermediate holding company to own its financial operations. That intermediate holding company would be effectively treated as a bank holding company.

Tier 1 FHCs would be subject to "enhanced" capital, liquidity, and other requirements. At a minimum this would include the requirement to be "well capitalized" and "well managed", but that requirement would apply to any financial holding company under proposed Title VI.

### **Title III - National Bank Supervisor**

Title III would replace the OCC and OTS with the new National Bank Supervisor (NBS). Title III would also end the federal savings bank charter so that all existing federal savings banks would have to convert into national banks, mutual national banks (as newly authorized by Title III) or state commercial or savings banks.

### **Title IV - Registration of Private Investment Pool Advisors**

Title IV would require that an adviser to any pool of capital currently exempt from the Investment Company Act under Section 3(c)(1) or 3(c)(7) register with the SEC under the Investment Advisers Act, so long as the investment adviser managed at least \$30 million. Unlike a similar 2004 SEC rule that was found to be unlawful, this legislative requirement would not only apply to hedge funds. The proposal would cover all private investment pools (including venture capital and private equity) and, with narrow exceptions, foreign investment pools if at least 10% of their securities are owned by US investors.

### **Title V - Office of National Insurance**

Title V would establish an Office of National Insurance that would monitor insurance companies and recommend to the Federal Reserve insurance companies to designate as Tier 1 FHCs. Although this would establish a new federal "monitoring" of insurance companies and of their regulation, insurance companies would continue to be regulated by states.

### **Title VI - Bank Holding Company Act Improvements**

Title VI would eliminate the "loophole" under which credit card banks, industrial loan companies, "non-bank banks" and others were not considered "banks" under the bank holding company act. Their owners would now be subject to Federal Reserve oversight as bank holding companies. Title VI would also expand the scope of Federal Reserve Act 23A to treat as "covered transactions" credit exposures under derivative and securities lending transactions and to treat more broadly as a covered affiliate any fund advised by an affiliate of the member bank.

**Title VII - Regulation of Derivatives**

Title VII would dramatically alter the “over-the-counter derivatives” market by giving the CFTC and SEC authority to determine what is a standardized derivative (which would be required to be traded and cleared through a regulated facility) and what margin, capital, and other requirements would apply to non-standardized derivatives and the parties (other than banks) that deal in them. Banking regulators would be directed to apply the same types of standards to banks. Non-standardized derivatives transactions would have to be reported to regulators to permit monitoring of positions.

**Title VIII - Regulation of Financial Market Utilities**

Title VIII would give the Federal Reserve new powers to designate and then regulate any “financial market utility” (such as a payment, settlement, or clearing system) that is “systemically important.”

**Title IX - Additional Improvements**

Title IX is divided into 5 “subtitles.”

**SUBTITLE A - EXPANSION OF CUSTOMER DUTIES**

Subtitle A would authorize the SEC to apply the same customer duties (most notably “fiduciary” rather than merely “suitability” standards) to broker-dealers as investment advisers and to require delivery of sales materials or other information before rather than after sales. It would also make permanent the SEC’s “investor advisory committee” and authorize consumer testing.

**SUBTITLE B - SEC AUTHORITY TO RESTRICT ABILITY OF BROKER DEALERS TO REQUIRE ARBITRATION**

Subtitle B would give the SEC broader enforcement authority and allow it to restrict the ability of a broker or dealer to require arbitration with its customers.

**SUBTITLE C - SEC RATING AGENCY OVERSIGHT**

Subtitle C would give the SEC greater authority over rating agencies and would require certain protections against conflicts of interest at rating agencies.

**SUBTITLE D - EXECUTIVE PAY**

Subtitle D would require public companies to include in proxy statements a non-binding shareholder vote on executive pay and would establish rules for the compensation committee and executive pay consultants of listed companies.

**SUBTITLE E - SECURITIZATION REFORMS**

Subtitle E would require the SEC and federal banking regulators to establish rules requiring “securitizers” (issuers or underwriters) to retain at least 5% of the credit risk of securitization transactions that meet the eligibility requirements of SEC Rule AB. At least as proposed, therefore, this requirement would not apply to the many types of private transactions (such as most ABCP conduit securitizations) that would not be eligible for Regulation AB treatment. The rules (however they may be adopted by the SEC and banking regulators) would apply to eligible transactions even if not sold in a public offering permitted by Regulation AB. Subtitle E would also require increased loan level and rating agency disclosures for public securitization transactions.

### **Title X - Consumer Financial Protection Agency**

Title X is perhaps the most controversial proposal. It would establish a Consumer Financial Protection Agency (CFPA) that would take over federal consumer protection authorities currently held by federal banking regulators. The CFPA would, like the SEC and CFTC, have 5 members appointed by the President, with the difference that the new Director of the National Bank Supervisor would be a member. The CFPA would have broad discretion to issue and supervise rules to ensure “consumers have and understand information to make decisions about consumer financial products”, that consumers are “protected from abuse” and that “all consumers have access to financial services.” The Federal Reserve and other bank regulators have argued they should retain the consumer protection powers they have under existing law in order to integrate that authority with their overall authority over banks.

Title X would also overturn existing federal preemptions of state consumer protection and other rules for national bank and other federal institutions. The days of different products for different jurisdictions would likely return.

### **Title XI - FTC and CFPA Consultation**

Title XI provides for consultation between the Federal Trade Commission and the new CFPA.

### **Title XII - Resolution of “Systemically Important” Companies**

Title XII is the Treasury Department’s attempt to deal with the widespread complaint that in 2008 federal regulators did not have sufficient authority to “resolve” Bear Stearns, Lehman Brothers, AIG and other troubled “systemically important” companies. Under Title XII, any Tier 1 FHC and any bank holding company (even if not a Tier 1 FHC) could be subject to bank style “resolution.” The model would be the FDIC’s broad authorities in “resolving” banks, including authorities much broader than those in the Bankruptcy Code to avoid contracts, security interests, and other claims and to transfer “qualified financial contracts” such as derivatives or repos.

Critically, the Treasury Department would have the discretion to use these special rules but would not be required to do so even for the largest and most active Tier 1 FHCs. The Treasury Secretary, in consultation with the Federal Reserve Board and the FDIC or the SEC (if the largest subsidiary by assets is a broker or dealer) and only with the recommendation of 2/3ds of the members of the boards (for the Federal Reserve and FDIC) or commission (for the SEC) , would decide whether “resolving” that company and its non-regulated subsidiaries under the Bankruptcy Code would have “serious adverse effects” on financial stability or economic conditions in the US. If so, the Treasury Department could invoke the special resolution rules (to be administered by the FDIC or SEC) to resolve the holding company and any of its subsidiaries other than a regulated bank, broker-dealer, or insurance company. Those regulated companies would continue to be subject to the special federal or state rules that apply to their insolvencies.

**Title XIII- Treasury Approval of Federal Reserve Emergency Lending Authority**

Title XIII would require that the Treasury Secretary approve the Federal Reserve's use of its "emergency lending" authority. While the Federal Reserve's 2008 use of that authority was supported by then Treasury Secretary Paulson, this is considered by some an important "check" on Federal Reserve authority and, by others, as undercutting its independence.

**LEGISLATIVE DEVELOPMENTS**

The Federal Reserve Bank of Saint Louis maintains on its website a useful page (<http://www.stlouisfed.org/regtimeline/pdf/Timeline.pdf>) that tracks the progress of the various financial reform proposals and provides links to hearings and other materials. We will issue further updates describing in more detail specific parts of the legislation currently proposed and will follow further developments.

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